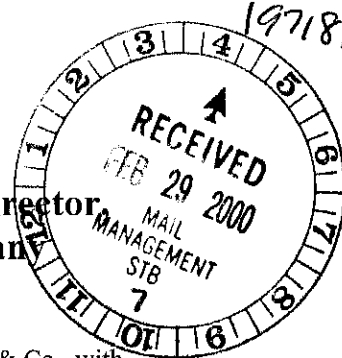


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**Written Testimony of James J. Valentine, Managing Director,
on behalf of Morgan Stanley Dean Witter & Company
in STB Ex Parte No. 582**



My name is James J. Valentine and I am a Managing Director of Morgan Stanley Dean Witter & Co., with responsibility for researching the North American railroad and trucking industries for our equity division. I have been conducting this type of research for 8 years. For the past 4 years I have been ranked as one of the top three U.S. railroad analysts by the two most notable institutional investor polls. I hold a masters degree in Finance from the University of Iowa and am a Chartered Financial Analyst (CFA).

I would like to thank Chairman Morgan, Vice-Chairman Burkes, Commissioner Clyburn and the STB staff for allowing me the opportunity to present this testimony.

I've been asked to provide a view from "Wall Street" with respect to railroad industry consolidation, which can take on many meanings, given all of the constituents that make up the financial community. Therefore, let me start off by clarifying the perspective I hope to offer today. My primary role as an equity research analyst is to offer insights to institutional investors as to the *future prospects* of the North American railroads. These investors are the ones that share the successes and failures of the companies they own, and as such, I have turned to them for *their* perspective on railroad industry consolidation.

Let me also state that Morgan Stanley Dean Witter is currently not representing any railroad in the current round of merger negotiations taking place. If we were, it would be difficult for me to provide an objective, unbiased testimony.

In order to get a view from the institutional investors, my team surveyed approximately 100 of the largest U.S. and Canadian money managers who currently own or have owned substantial positions in the railroads. The survey consisted of 6 questions which are found below. Of the 100 individuals polled, we received 22 complete responses, which is a good response rate for surveys, especially given the tight time constraint.

Conclusions

Based on the responses from the survey, we can make the following conclusions:

- For the most part, the financial community does not want to see the railroads regulated further.
- There is an even split between those investors who believe that industry consolidation should be "allowed to continue as it has in the past" (50% of the respondents) when compared to those that believe it should be "put on hold", "stopped" or the process modified (50% of the respondents).
- Even though there is no clear consensus on how industry consolidation should proceed, only 5% of respondents would unconditionally buy railroad stocks at current valuation levels (or buy more if they already own them) "if a new round of railroad industry consolidation starts this spring." Approximately half of the respondents (45%) said they would sell existing railroad stocks if another round begins and the remaining 50% gave conditional responses which we discuss in detail below.
- With respect to the last round of railroad mergers, institutional investors rated CNI/IC as a 7.9 (with "10" being excellent and "1" being a disaster), the BNI/SFX as 6.1, UNP/CNW as 5.0, CSX's and NSC's split up of Conrail as a 3.0 and UNP/Southern Pacific as a 2.1.
- Investors believe that railroad management conducts mergers to "compete more effectively with trucks" and "reduce costs" ahead of "enhancing shareholder value." Investors believe management has placed even less importance on "eliminating a weak competitor", "reducing capital expenditures" and "creating a stronger management team."
- As can be seen in the responses below, there was a common theme from shareholders that railroads can cure many of their ills by improving customer service.
- Another common theme was that investors want "stability" but this is defined in different ways. To some, this means no more mergers for the time being, while for others it means that the government should not make changes to the regulatory environment (i.e., the less government is involved, the better the prospects are for the railroads).

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In an effort to provide an unbiased testimony, the full and complete responses from every institutional investor who replied to our survey can be found below. Each paragraph represents a distinct response to the corresponding question.

QUESTION #1

Given the purpose of these proceedings, we wanted to gauge investor sentiment towards future mergers. Therefore, the first question we asked was “**In your view, future railroad industry consolidation should be...**” and included four possible choices.

Here were the responses:

___ allowed to continue as it has in the past	(50%)
___ put on hold until the industry improves customer service	(27%)
___ stopped indefinitely	(9%)
___ other (please specify):	(14%)

Additional Feedback on Question #1 included:

- Those who responded that railroad industry consolidation should be “*allowed to continue as it has in the past*” provided the following commentary:

The nature of the industry I believe demands economies of scale, one of which is the elimination of "handoffs" between multiple railroad companies. I think the rail companies can give the best service if they can provide "origin to destination" service on a single line. The current consolidation trend will permit this.

Despite recent service problems caused by consolidation it still remains the case that rail as an alternative form of transportation should in the long-term benefit from further consolidation from a customer standpoint. A few years ago we worried about monopoly pricing as airlines consolidated only to find that air travel became more affordable.

Future consolidations will be end to end in nature thereby avoiding some of the integration issues while ultimately leading to improved service relative to the current industry structure

Service levels were fairly dismal to begin with. By allowing the better competitors in this latest round to acquire lesser performing companies, we should see improved service. Ultimately, 2 national railroads competing across most of the country would be the best answer.

A proposed merger either has merits or it does not, waiting a few years makes no economic sense and is unlikely to change the levels of service. Either the two companies are able to merge effectively or not. Possibly more emphasis should be placed during the review process on the odds of success and the management, operating, and financial ability to deliver on the combination. Absolutely, the stability of the two combining companies should be an issue as it is critical to the odds of success, but two healthy companies should not be held back from improving returns and service because the rest of the industry is dysfunctional.

First of all, it's a free market economy. Second, most of the mergers make strategic and economic sense. The problem is execution, which the railroads EVENTUALLY get right. That they get punished (stock prices, earnings) along the way is something they have to live with and try to avoid by being smarter than they have in the past. That, unfortunately, seems to be asking a lot of this group, but one must have the long view, which is that the mergers work out and make sense.

Why wait for the ultimate goal of coast to coast one line service and all of its benefits, including lower costs and faster transit times? It's ultimately worth the pain, and if a rail gets it wrong, it will get penalized appropriately by the market and its customers.

Probably the most efficient rail system is coast-to-coast, north to south, even if it entails some pain to get there.

- Those who responded that railroad industry consolidation should be “*put on hold until the industry improves customer service*” provided the following commentary:

Deteriorating quality of customer service during the merger process causes far more long term problems for the industry resulting in market share losses (difficult to regain) to other modes.

The prospect of single-line, national shipping is appealing to most shippers (in my view) if one simple condition is in place: competition. Even if the choice is among only two carriers, this creates competition in both price and service. As such, an indefinite stop to consolidation is not the answer, nor is unfettered M&A activity. The industry needs to digest the acquisitions of the last few years and improve customer service. Furthermore, the rail system should be thought of as an optimized network. We need time to assess the great changes to both capacity as well as shift in traffic lanes on the overall network. The more changes we make to the system before the system can actually respond to those changes is problematic (when a pilot continually adjusts the controls of the aircraft during landing before the plane can respond to the inputs, the plane will never line up for the runway -- this term is called "pilot induced oscillation" and is a common mistake among rookie pilots). We currently have "railroad management induced oscillation" in the national infrastructure. We need time to see the effect of these recent system inputs.

Rails need time to strengthen existing franchises to prove to customer bases that they can be a reliable and valuable service provider so that alternative forms of transport are not given any further chance to steal share. Would like to see a moratorium of 3-5 years. This would also prove to be decent enough time for rails to prove how valuable their franchises are and for stock price recovery to follow.

Railroad structure today makes more economic sense than prior to consolidation. The benefits from this structure have yet to surface. Railroad re-configuration has been much tougher than anyone expected. Doesn't mean to deal so far should be reversed, but definitely want to freeze current structure until existing mergers are running smoothly.

Prove they can live up to their promises of efficiencies.

Industry needs to improve return on capital (ROC). Historically, mergers have required capital infusion which temporarily reduce ROC. The industry is in reasonable balance now and the BNSF-CN merger would be an escalation that would require a response by UP. This is likely to result in depressed returns on that system as well and raise further service and regulatory issues.

- **Those who responded that railroad industry consolidation should be "*stopped indefinitely*" provided the following commentary:**

I believe in competition, and all these mergers have taken too much out, without corresponding benefit in service and efficiency.

I'd like to see further consolidation stopped indefinitely, but am not sure that there are the legal grounds to do so.

- **Those who responded that railroad industry consolidation should be "*other (please specify)*" provided the following commentary:**

Allowed to continue, but with higher standards for approval now that so few rails are left. With only a few major rails left, we need new criteria to evaluate and regulate mergers. Therefore, the STB needs a higher standard for the industry with new conditions for approval. However, deals with real benefit (like BNI / CNI) should still be allowed to be completed if they will meet these criteria (whatever they turn out to be).

Railroads should be forced to unbundle their business lines into real estate rental, equipment rental, operating corridors, and customer service logistics companies. These entities would run as self-standing independent businesses and allow the market to efficiently allocate resources nationwide.

Consolidation is both necessary and value-enhancing (if done right). It should be "allowed to continue"...but not "as it has in the past". The issue isn't "consolidation", but "accountability". Consolidation shouldn't be put on hold, but planned and implemented differently and with greater accountability to the government, rather than just the shippers. The end result would likely aid outside shareholders as well. My thought is changing the role of the STB, coincidental with changing the accountability of the rails. While the issue is indeed customer service, the

companies' management and boards cannot be regulated into improvement. They must be incentivized and held accountable to outside shareholders and the government for that service. "Consolidation" isn't the enemy for the shippers, although I'm very sympathetic to their struggles, particularly as it exacerbates the problem, i.e., "monopoly" culture of the rails. Unfortunately, the industry economically should be consolidated, but like any near-monopoly, it must be policed to a greater degree as a natural outcome. "Insufficient accountability/punitive outcome" is the issue for the rails. There needs to be a sense of urgency for the rails to improve service - with or without further consolidation. The STB shouldn't and can't regulate it, but perhaps they can work with railroad boards (on behalf of shareholders and shippers) to jointly create a plan for service improvement. In place of re-regulation or, conversely, nixing all future mergers, the STB's role could be legislated into a more policing mode with clear consequences, i.e., fines to the rails, for not meeting service goals jointly developed among all interested parties. It may be unprecedented, but a sort of policing role giving the STB authority beyond the "big stuff", i.e., re-regulation, merger approval, might resolve the customer service issues over time.

QUESTION #2

The second question was asked in order to see if shareholders had distinguished certain recent prior mergers more successful than others. We asked **"From a shareholder's perspective, rank the success of each of the following mergers from 1-10 ("1" being a disaster and "10" being excellent. Do not put a number next to mergers you're unfamiliar with):"**

Here were the responses, ranked from highest to lowest:

- ___ CNI/IC (7.9)
- ___ BNI/SFX (6.1)
- ___ UNP/CNW (5.0)
- ___ CSX/NSC/CRR (3.0)
- ___ UNP/RSP (2.1)

We asked the shareholders to "Elaborate if desired" to which we received the following responses:

The returns to shareholders as exemplified by the stock prices has been underwhelming. The need for huge capital expenditures increases has been a drag on the return. But the fact that such capital was invested POST merger where it wasn't before is in and of itself a justification for the mergers. Lets assume the capital was needed, and wasn't wasted; thus the merger was the trigger to get the investment done. Don't customers benefit then as a result?

I think its too early to tell on the breakup of Conrail for NSC and CSX but the initial results have been disappointing.

The ones that worked, didn't work at first. So, the mergers shouldn't be judged by their immediate results.

End to end works best... as does pragmatism over arrogance.

QUESTION #3

The third question we asked was to better understand how shareholders perceived management's priorities in conducting a merger. Specifically, we asked, **"From a shareholder's perspective, when a railroad consolidates with another, where does management (or its Board of Directors) rank the importance of each item below? Rank from 1-10, with "1" = not important at all and "10" = extremely important."**

Here were the responses, ranked from highest to lowest:

- ___ compete more effectively with trucks (7.5)
- ___ reduce costs (7.2)
- ___ enhance shareholder value (5.5)
- ___ eliminate weak competitor (4.9)
- ___ reduce capital expenditures (4.5)
- ___ create a stronger management team (4.4)

We also asked if there were “other” items to be considered for this question, and 5 respondents replied that they thought management placed a high degree of importance on things such as “personal issues”, “enhance management’s careers” “be the biggest” and “empire building”.

QUESTION #4

It is typical to see consolidation in industries where the major companies do not earn their cost of capital, as consolidation can often lead to better margins and less use of capital. Yet during the most recent round of railroad industry consolidation, returns deteriorated from where they were before the round began. Therefore, we posed the following question to our institutional investors: **“Railroads have not earned their cost of capital for over 30 years at a time when they have been losing market share to trucks. If these trends continue, will railroad be able to attract new capital? Do you believe it will be necessary for railroads to consolidate/merge to reverse these trends? Why?”**

Responses:

I do think that railroads have a long way to go before they reverse these trends. Consolidation is one of them. Others could include faster implementation of new technology, more forward oriented management teams, more aggressive marketing and pricing policy, increasing focus on the out of the railroad industry competition.

The cost of capital is an antiquated number based on archaic book values. I don't think the industry needs "new" capital, because, if they run the roads right, they should be self financing. I would rather look on incremental cash returns on incremental investment over a period of time. A big problem the rails have is that the asset base cannot be liquidated, except to someone who continues in the business. Therefore, there is no real alternative to maintaining the infrastructure because the alternative is an even faster destruction of "value". I do not believe merger/consolidation solves anything. In fact, someone, maybe even you, told me that one of the major problems with the CRR carve up was that CRR's old choice of alternative routes disappeared to each of its devourers. Similarly, in other mergers, some lines get eliminated or under-maintained, keeping them from being a safety valve if there is a main line problem.

No (railroads will not be able to attract new capital). Yes (it will be necessary for railroads to consolidate/merge to reverse these trends). The ideal situation is a railroad duopoly comprised of two true end-to-end scheduled NAFTA railroads that can compete with trucks while providing superior customer service.

No, they certainly won't get equity capital. I also do not believe they need to merge to reverse this trend. They need to stop trying to be growth businesses and just do their niches well and throw off cash to de-capitalize.

One could write a book on this subject. I for one don't necessarily agree with the cost of capital analytic, although I acknowledge that it is an important barometer. The accumulated earnings of the US airline industry over the last thirty years is BARELY breakeven. So does the airline industry earn its cost of capital over long cycles? Yet there is generally access to public and private capital in that sector. The reason?? Inefficient companies generally die and new ones (promising better equipment or better SERVICE) win or replace them. This is possible in a paradigm where the government controls and allocates usage of the network pathways. In the rail industry, where the companies own the pathways, inefficient operators aren't generally eliminated because they own the path. If inefficient operators stay in the game, the prospect of gauging returns on investment is difficult owing to the "wild-card" that the inefficient operators represent. This means vibrant public and/or private capital is spotty.

The recently completed consolidations make strategic sense and should help railroads to be more competitive vs. trucks; unfortunately, the prices paid by the acquirers will make it very difficult for them to earn a good return on their investments, particularly the goodwill. Going forward, its not clear to me that there is big bang for the buck in further consolidation; certainly not enough to merit big premiums paid. As for getting better returns on cost of capital, the railroads ought to be able to do it - they provide a very valuable service at a large discount to the next best alternatives - but it will require better capital management and a concerted effort to capture the value that they are leaving on the table.

The rails are essentially of no interest to investors because of slow growth and low ROIC (return on invested capital). The slow growth is here forever, so only higher returns will attract interest from investors.

Yes (it will be necessary for railroads to consolidate/merge to reverse these trends), in an increasingly mature industry, consolidation is one of the few ways to add/enhance capital positions.

No, railroads will not be able to attract new capital if trends continue. Moreover, shareholders will become even more vocal that railroads return the capital that they generate rather than re-invest it in the business. Since recent mergers have been colossally bad for return on capital, the railroads do not need further mergers to improve their returns. Indeed one could argue that the best way to improve returns would be to stop merging.

No (railroads will not be able to attract new capital) and No (it will not be necessary for railroads to consolidate/merge to reverse these trends). Failure to earn cost of capital will require more monopoly power, which means even more radical consolidation in this industry or outright government controls. Neither are attractive solutions.

No (railroads will not be able to attract new capital) and No (it will not be necessary for railroads to consolidate/merge to reverse these trends). Railroads need to unbundle to efficiently allocate capital, and need to get smaller to render effective customer service. If they do not do this, they can disappear. Non-railroad customers will gain market -share. Freight railroads could shrink like in Europe, or disappear like in Japan. Size is a costly detriment to service. Mergers would enhance their retreat.

If these trends continue, Yes, railroads will be able to continue to attract new capital. If times are good. In good times it seems any screwball idea can attract capital. BUT - the cost of that new capital will be sufficiently higher that it will exacerbate the situation, and dig the hole deeper.

I think the advent of better information systems, the completion of the consolidation phase for the industry and reduced capital spending over the next few years will all lead to an industry that can earn its cost of capital.

They will find it difficult to raise value. Railroads will earn cost of capital or even excess in cost of capital if they can provide the service shippers desire. To the extent that mergers will improve service, they will attract the requisite funds.

No (railroads will not be able to attract new capital). Yes (it will be necessary for railroads to consolidate/merge to reverse these trends). Efficiencies and cost reduction carried out over a larger company should have greater impact.

There are currently too many railroads with poor service and little incentive to change. Return on Capital Employed (ROCE) has never been a major preoccupation with them. By allowing railroads to either merge or fail (though the latter would be unlikely from a political perspective), better competitors should be able to rationalize operations and improve returns. Here again, the difference between CNR and the US domestic railroads is glaring.

The railroad industry has already seen its ability to attract capital diminish dramatically relative to other large corporations. Five years ago, railroads could raise equity close to the level of the average company (i.e., the price/earnings ratio was close to market's) but now multiples are significantly lower so cost of equity is higher. The only way to attract more capital is to raise return on capital. The only two ways to accomplish that is to take capital out of the business (downsize, consolidate) or boost returns on existing capital (more revenues, higher pricing, better asset turns).

The concept of increasing scale to improve returns is valid long term. In the current environment, with heightened concerns among shipper and legislators over poor service, and lack of interest by institutional shareholders, it seems the railroads should focus on improving service which should lead to better returns. There should not be a great urge to dump more capital into the business at this time unless it has the prospect of earning a return better than the cost of capital. Admittedly, service can be improved if interconnects between systems are eliminated and this argues for further consolidation. However, the rails seem to have a long way to go to improve their internal systems which should also lead to better customer service. Most other industries have benefited significantly by increasing the technology component of capital spending. This fact seems to have eluded the railroad managements.

Consolidation/merger MAY allow for more capital to flow into the industry, but the core question is how to get these companies to realize they're in a service business and improve their thinking--which I believe will lead to the more tangible improvements needed to run operations more efficiently. This will lead to higher margins and higher returns on capital. A vicious capital cycle CAN become a healthy one.

Maybe ROI-WACC (return on invested capital-weighted average cost of capital) is the wrong determinate of "success". There is enough time-insensitive, cost sensitive freight, especially bulk, to support this business for many more years. Whether the industry can attract more capital in a market that values companies with no earnings at 100x sales is another question. The trucking share question is an interesting one and the answer depends on how you want to slice the economic data. I am not that concerned about it in the short run, especially as certain rails fine tune their intermodal products and as the scheduled railroad concept gains acceptance. If a merger happens to improve the share of rails via better service, though, I do not see how regulators can oppose it as long as competition is maintained. I do not think that mergers are necessary to achieve this state, but can help.

No (railroads will not be able to attract new capital): look at the steel industry, where managements have consistently failed to enhance shareholder value, and the stocks become trades. While it's true they are different, i.e., hard cyclicals, plus there's a case the U.S. is competitively disadvantaged from a cost perspective, relative to other countries, the analogy still has merit, in my opinion. There, as with the rails, there's still opportunity to improve their returns, and they remain reluctant to do so. As a result, no one believes the managements, and no one thinks anything but a short, intermittent rally is a viable investment strategy. The rails are relegating themselves into the same category, perhaps as a play coming out of a recession. Yes and no (with respect to railroads need to consolidate/merge to reverse these trends). Yes, because of the economics, i.e. capital intensity, inherently limited flexibility due to a fixed footprint, etc. "No", because we may not be "there" yet, even as I subscribe to the economics driving the need to consolidate, eventually. "Self-help" and actively and aggressively seeking out new business, borne of internal operating and service improvements, remain opportunities. We simply don't know what self-help could do to conclude they must consolidate immediately. We're all still waiting to see what they can do on their own. Truckers aren't the current problem - rails themselves are their own worst enemy. All that said, if they'll never "get there" on their own, consolidation is the only way to reverse these trends, at least for some period of time - when low hanging fruit like consolidating back offices - can be implemented.

QUESTION #5

We can ask institutional investors for all of the feedback that they can provide, but in the end, they often will "vote with their shares" by selling stock of companies that have poor prospects and by buying stocks of companies that have good prospects. Therefore, we asked, **"If a new round of railroad industry consolidation starts this spring, what will be the reaction from institutional shareholders, assuming valuations remain where they are today?"**

Here were the responses:

- _____ buy railroad stocks (or buy more if already owned) (5%)
- _____ sell existing railroad stocks (or avoid the group) (45%)
- _____ it depends (explain): (50%)

For the "it depends" choice, we received the following explanations:

Depends on the timing (quality of service at that point of time), names of consolidators, purpose/long term potential of consolidation, impact on the industry/shippers, general market environment.

If the process starts this spring and has a reasonably aggressive timeline, I will continue to hold current positions (market weight) which is a reduced weight from the time of the CN/Burlington Northern merger announcement. However, if the process starts this spring but the timeline is too soft, I will probably reduce my positions further.

BNI /CNI in a vacuum would be a good transaction which would be a positive. But if more carriers try to do something new than this would be a disaster.

Value or income-oriented investors may invest where dividends look attractive, but it is hard to imagine anyone getting involved "until the smoke clears" two years later.

Based on my limited history with the group, my perception is that the bad deals had two characteristics: 1) the acquiring company overpaid in a huge way, which meant that financial returns would be awful; and 2) the rationale was not logical or was poorly conceived (bidding wars, etc). Deals do not financially impair the merged companies and which are well planned and have demonstrable benefit to shipper should still be approved.

While I have witnessed the ill effect of the short-term impact on share values from large scale mergers, the longer-term potential still holds some appeal. However, the merits of any strategic change to the industry and its impact on share value is measured against alternative investment opportunities.

Merger needs to be end to end. Biggest overhang on rail stocks is the inability of NSC and CSX to successfully integrate Conrail.

If the mergers are driven by ego, or a response to someone else, the (institutional investor's) reaction will be negative. If there is an economic logic the reaction might be neutral or positive. The key issue is investor perceptions as to what the government response would be to the consolidation and whether the combining companies have the ability to effect a smooth transition. More regulation driven by a reaction to more mergers would cause investors to sell. Two weak companies combining just to get bigger would cause investors to sell.

Hard to say. Valuations are already depressed and one of the reasons is that the BNSF-CN proposed merger is perceived as raising the risk of a negative regulatory response as well as destabilizing the current "balance" among existing competitors i.e. it will stimulate another round of consolidation among the remaining players. Further merger announcements could alleviate some of the competitive concerns, but it is unlikely that such announcements would be well received by shippers or regulators. In my opinion, the three catalysts that would get the group moving are 1) an announcement by the STB that it was either rejecting or deferring approval of the BNSF-CN merger (eliminate the catalyst that caused the recent sell-off), 2) any announcement that suggested the group's prospects for earning a higher return on capital or 3) an economic slowdown could attract investors to the group who are interested in playing a cyclical upturn.

If NSC/SCX/CRR keeps improving and the economy holds together and (mirabile dictu) the rails actually start to reverse the trend of truckers gaining share then the old "Railroad Renaissance" story starts to surface again. Besides, with valuations beaten down to their present levels, investors are eventually going to look for any excuse to BUY these stocks.

Some rails will be better positioned by choosing their merger partners rather than being forced into a partnership

We received the following responses from those who had chosen "sell existing railroad stocks (or avoid the group)":

An investor is always asking one question: "Why buy now?" If an investor can answer the question, they buy. There is no reason at all to own rail stocks with the operational uncertainty that exists during the STB review and for months (years?) following the merger. There is no reason at all to own rail stocks with the labor uncertainty that consolidation will bring. There is no reason to own rail stocks when there is a massive degree of execution risk associated with a mega-merger. Lastly, if the past is any indication, the buyer will overpay and stress the balance sheet -- thereby hurting returns even more.

Too much uncertainty about profitability and meltdown.

1. The cloud of uncertainty over the industry will linger for 2+ years. 2. To date, mergers have been bad for returns on investment. 3. When railroads merge, they generally overpay for their acquisitions. 4. Risks of unfavorable regulatory changes increase exponentially. 5. Consolidation will delay when railroads earn free cash to return to shareholders.

Other RR's will be forced to react. They are not ready, and existing mergers would be compromised.

Why? They need to prove they can improve with consolidation.

I think institutions will view it as a risk of "dead money" while waiting for the mergers to close, and then the spending to begin, and the inevitable service disruptions to take place, before the dust settles and the systems resume "normal" levels of profitability. But now is the time to do it anyway. What the heck, go all the way NOW. Look at UNP - why is it trading where it is with all the progress its made? I offer one answer - the rise in interest rates. If the 10-year bond would turn around and rates go down, then I think you'd see UNP move up on that alone. But rates aren't going down now, are they? So you might as well take advantage of the situation - i.e.: nothing is working right for the stocks, so how much worse can they get messed up?

Don't count on the railroads getting it right this time.

Definitely a "show me" situation. These guys (railroads) haven't shown they can materially, consistently increase shareholder value on their own or via a merger.

QUESTION #6

If you could convey one message to the Surface Transportation Board about your view towards railroads as an investment, it would be:

Look in the long term competitive position of the industry.

No more mergers, and eliminate all vestiges of rate regulation.

There is a large gulf between the old economy and the new economy stocks at the present time with the railroad stocks considered to be old, old economy. The STB has to recognize the importance of the Hunter Harrison and Paul Tellier scheduled railroad vision. If anything, this vision needs to be more aggressive as it will be necessary for the old and new economy stocks to merge and morph to survive. AOL buys Time Warner! - or more recently, Ford, Oracle and Cisco team together!

Currently, railroads are a poor investment. One could argue that money has been made owning them (Anschutz for example), but I would argue that has not really been the case for 50 years. Government re-regulation is NOT the answer. Investment returns will become more visible after the dust settles during the next several years. Additionally, technology improvements will continue to help the industry (particularly -- fingers crossed -- in the customer service area).

Railroads can be good investments and productive service providers provided that they have a stable regulatory environment that does not unduly fetter the service offerings that they provide nor the price that they can charge. That said, I think that a moratorium of 3-5 years on further consolidation would ensure that the next round be done when the industry is stable, has proven that consolidation works, and has learned from its mistakes from the last round, both operational and financial.

The focus on customer satisfaction should ultimately be decided by the success of each deal, with shareholders bearing the risk. Such risk should not be decided by the regulators. Regulation, as it is written today, is set up to protect the industry's growth and economic health. Neither are issues in today's environment, and they are not likely to be issues in the future.

Do not change current regulatory regime. As it is, railroads cannot earn their cost of capital. Redistributing property through open access regimes will only make matters worse.

Take a look at last couple of years. Bad investments. Big users of capital without adequate economic returns. If you want capital flows to this industry and government wants to take heavy freight from the highway to the railway, then this industry had to be reconfigured like it is today. If government re-regulates this industry, it would be a huge mistake. Go back to Conrail case-- government was lucky to get rid of it since government has no idea of how to run a railroad. PRIVATE solutions are preferred, and STB has done a great job to balance competing interests in railroad mergers. Linda Morgan's vision is excellent. Don't limit her ability to seek fair and solid economic solutions to railroad problems and issues.

Force true vertical unbundling of this industry. Let the market determine whose railcars and locomotives are used anywhere, let the most effective customer-service organizations gain share anywhere. Let the most efficient operators run regional corridors in an incentive-based rate environment. Let the real-estate get a regulated return based on competition for the rights to operate. Stop the egomaniac empire-building.

To promote a healthy industry long term we need an industry that earns its cost of capital. STB should do everything in its power to set an environment where this can happen. The industry has claimed that it needs to merge in order to gain the economies of scale needed to compete against the subsidized trucking industry (or have they forgotten about that minor detail). They've also said the handoffs between railroads add a great deal to the slowness in traffic. So, my message to the STB is to let the rails form Continent-wide networks, to see if they can finally make it work (defined as earn their cost of capital).

I don't think the STB should be concerning itself with the investment potential of railroad stocks. The STB is a government regulatory body not an investment advisor.

Keep the regulation to a minimum. Rails have decreased rates in real terms dramatically thanks to deregulation. Industry obviously is competitive and has no monopoly pricing power. Now rails have the chance to dramatically improve service by moving to two transcontinental systems. Everyone benefits, especially as it reduces trucks on the highway. In the current economy the transportation system is showing evidence of a bottleneck created by driver shortage. It's not an issue about truck vs. train competition, it's an issue of adequate infrastructure spending. Help railroads provide adequate infrastructure for our economy by allowing them to merge. The reduced emissions and reliance on OPEC as a result of reduced truck traffic are added positive externalities to a health railroad system.

Keep the government's hand out of as much as possible - let economics and capitalism run its course.

Either nationalize the whole thing and spend billions upgrading the facilities... or let the market do it unhampered. A constraining regulatory environment only delays the inevitable and allows non-competitive behaviors to continue.

They are not excessively profitable! Most likely, if they are regulated on a return-on-capital basis, they might earn more than they do today.

Either this industry is able to boost return on capital or the cost of capital will continue to rise, availability of capital will shrink and management will be forced to take capital out of the business (i.e. invest less). Any government action which restricts the industry's ability to improve returns over the short run will inevitably lead to less capital investment and poorer service over the long run. If returns do not justify continued reinvestment, the industry must shrink and reduce service options to only those customers that earn the highest returns. The government should approve or reject merger proposals based on the ability to boost or destroy returns. Do not reject a merger because of timing. Reject it to save the industry from destroying more value or ruining service (i.e. driving returns down). But if the merger can and should boost returns on capital and improve service options to customers you should approve it because ultimately it will allow more capital to flow to the industry over the long run.

We sold our rail holdings in the last year. Using normalized earnings 3-5 years out, many of the stocks in the (railroad) group look attractive. If we were convinced that the industry's focus had shifted to improving returns on capital, and that we could also benefit from a cyclical upturn, we would be willing to invest in the group.

This is an industry that is extremely vital to the US economy. Streamlining through mergers can ultimately have a positive effect on the overall economy. Don't start thinking about throwing the baby out with the bath water just because Union Pacific made some mistakes in the past. Similarly, don't get too hyper about the CSX/NSC/CRR problems. These are good operators who honestly tried to do their best ahead of time but got tripped up after the starter's gun went off. They will get it right, though. After all, UNP did! Lastly, look at what IC could do in a similar situation. And the BN/CN looks a lot easier to get right than most of the previous mergers. Don't, therefore, panic. And keep the politicians out of it as best you can because all they're going to do is stir up the pot (i.e., threatened re-regulation) because a PAC-paying constituent starts complaining about service--even though that constituent may be right.

The Government appears to have little clue as to how investors view this industry (hence your testimony). I am especially irritated at how the STB seems to view rails in a vacuum without considering competition from trucks and/or ships. They all haul the same stuff; the mix is just different. We should adopt a laissez-faire approach and let the industry figure things out on its own. The regulatory procedure is unduly onerous and is a poor substitute for a true free market for transport, which would allow the winners and losers to get sorted out more quickly. The STB process is costing investors money, making the industry less attractive to invest in and is clearly costing these companies billions in potential market capitalization. The STB can single-handedly ruin this industry by preventing natural selection, which by the way, should include trucking and shipping, not just rails. The best way to optimize the nation's transport infrastructure is to let it consolidate. If the rails end up with two North American players so be it, trucks and ships will still compete with them.

The rails are their own worst enemy - the culture is the problem. The solution isn't capitalist in nature, perhaps, but some kind of watchdog - a close, aggressive one - may be necessary to meet the needs of all constituents, i.e. shippers, shareholders. As investments, these are generally poor given the lack of urgency, the complacency, and the comfort blaming the environment (idea of derived demand), the companies tend to show. Their natural monopolistic nature makes them have to be regulated, but some closer, more accountable policing might be worth pursuing, in exchange for merger approval.